FitchRatings

Fitch Affirms Novatek at 'BBB-' on Nortgaz Acquisition Announcement

Ratings Endorsement Policy
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Fitch Ratings-London/Moscow-07 November 2012: Fitch Ratings has affirmed OAO Novatek's Long-term foreign and local currency Issuer Default Ratings (IDR) and senior unsecured ratings at 'BBB-' and its National Long-term rating and National senior unsecured ratings at 'AA+(rus)'. Novatek Finance Limited's foreign currency senior unsecured debt rating has also been affirmed at 'BBB-'. The Outlook on the Long-term IDRs and National Long-term rating is Stable.

The rating actions follow the announcement by Novatek that it will acquire a 49% stake in ZAO Nortgaz (Nortgaz) for USD1,375m in a fully debt-funded transaction. Novatek expects to close the transaction in 2012.

The transaction is likely to see leverage metrics breach the parameters Fitch has set out as likely to trigger a downgrade if sustained. However, the breach will be by only a modest amount, and based on conservative forecasts and past behaviour, Fitch expects that metrics will return to more comfortable levels for the ratings in one to two years. Until this happens, Novatek's capacity to undertake further acquisitions without jeopardising the rating will be limited. From a business perspective, the acquisition will further strengthen Novatek's position in the Russian gas market, and bring synergy benefits, albeit Novatek will share management with 51% shareholder OAO Gazprom (Gazprom, 'BBB'/Stable)

Fitch forecasts Novatek's funds from operations (FFO) adjusted gross leverage ratio will exceed the agency's current negative rating guideline of 2x in 2012, if the transaction completes this year, but expects it to reduce to around 1.7x in 2013-2014 following a gradual repayment of the company's debt. Fitch expects the company's FFO interest coverage to fall below the agency's current negative rating guideline of 10x in 2013, but to improve to 10x-12x in 2014-2015.

Fitch believes that the acquisition will be beneficial for Novatek's business profile, strengthening its position as the key independent natural gas producer in Russia. Nortgaz is likely to get access to Novatek's existing infrastructure giving rise to the synergy effect. At the same time, Nortgaz's post-acquisition capex, dividend and debt policy remains uncertain, as Novatek will have to coordinate all key management decisions with the second major shareholder of the company, Gazprom, which holds a 51% stake in Nortgaz. Consequently, Fitch has not included Nortgaz's possible dividends into its cash flow forecasts for Novatek, although this may change if Nortgaz demonstrates its ability to generate positive FCF after the acquisition.

Fitch's expectations are based on the assumption that natural gas prices in Russia will continue to rise by 15% p.a. in the medium term, according to the Russian government's commitment to liberalize the price of natural gas sold on the domestic market by 2015-2018.

In 2011, Nortgaz's production amounted to around 70 thousand barrels of oil equivalent per day (mboed), and its proved reserves amounted to 1.7 billion barrels of oil equivalent, of which 13% are liquid hydrocarbons. Nortgaz holds a license for production of gas and liquids at the North Urengoyskoye field, which is located in close proximity to the Yurkharovskoye field, Novatek's key producing assets, and to Novatek's gas condensate pipeline to Purovsky Plant.

Novatek is the second-largest natural gas producer in Russia with total hydrocarbon production averaging 861mboed (excluding equity stakes).

WHAT COULD TRIGGER A RATING ACTION?
Positive: Future developments that may, individually or collectively, lead to positive rating action include:
- Completion of Yamal LNG enhancing the company's business profile with greater access to export markets and more diversified operations
- Larger domestic market share to a level that makes Novatek a more serious Gazprom competitor
- Leverage consistently less than 0.5x; interest coverage consistently greater than 20x; and consistently positive free cash flow

Negative: Future developments that may, individually or collectively, lead to negative rating action include:
- Leverage consistently greater than 2x; interest coverage consistently less than 10x; and consistently negative free cash flow
- Large self-financed cash outlays for Yamal LNG development, majority debt funding of Yamal LNG through

Novatek's balance sheet, or Novatek guaranteeing a material portion of the debt attracted to finance the project
- Debt-financed acquisition-led growth strategy that results in a permanent departure from the presently conservative financial policy
- Rising domestic competition that results in loss of market share or competitive position

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Additional information is available at www.fitchratings.com. The ratings above were solicited by, or on behalf of, the issuer, and therefore, Fitch has been compensated for the provision of the ratings.

Applicable criteria, 'Corporate Ratings Methodology', dated 8 August 2012 are available at www.fitchratings.com.

Applicable Criteria and Related Research:
Corporate Rating Methodology